No. 14735

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

COMMISSIONER OF INTERNAL REVENUE,
PETITIONER

— VS. —

ROBERT H. MILLER AND DORIS K. MILLER,
RESPONDENTS

ON PETITION FOR REVIEW OF THE DECISION OF THE TAX COURT OF THE UNITED STATES

BRIEF FOR THE RESPONDENTS

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QUESTION PRESENTED

Whether the rentals paid by Respondents for the first year of the term of the Federal oil and gas leases are, in fact, true rentals and deductible under Section 23 (a) (1) (A) and Section 23 (a) (2) of the Internal Revenue Code of 1939.

STATEMENT OF FACTS

The Respondents are not in disagreement with the Statement of Facts as described on pages 2 to 6, inclusive, of Petitioner's brief except in so far as stated herein. At page 5 of his brief Petitioner quotes from Section 1 of the Noncompetitive Oil and Gas Leases issued to the partnerships of which Respondents were partners. A portion of Section 1 as quoted by the Petitioner reads:

> "That the Lessor, in consideration of rents and royalties to be paid, and the conditions and covenants to be observed as herein set forth, does hereby grant and lease to the Lessees the exclusive right and privilege * * *."

Further, at page 8 of Petitioner's brief, the following statement is made:

> "Although the advance payments in question are termed, variously, rents, rentals and/or royalties in the leases, this is clearly not significant for the pertinent decisions hold that these are all the same in nature and substance as advance royalties and so-called bonuses which the Lessee must capitalize and recover through depletion deductions."

In view of the fact that the above quoted portions of Section 1 of the leases, together with the above statement made by the Petitioner on page 8 of his brief may give rise to a misunderstanding, the Respondents desire to present as an absolute factual matter that the payments in question were designated and referred to solely as "rents" or "rentals" in the leases and wherever the leases used the terms "royalties" or "advance royalties," such terms were intended to refer to obligations other than the payments involved in this case. In support of this contention, the Respondents desire to quote the pertinent language from

the leases which refer to the payments in question in this case. Section 2 (d) of the leases (R. 36) states as follows:

> "(d) Rentals and royalties — (1) To pay the rentals and royalties set out in the rental and royalty schedule attached hereto and made a part hereof."

Schedule "A" to the leases appears in the Transcript of Record (R. 53) and is quoted as follows:

> "Schedule 'A'
>
> Rentals and Royalties
>
> Rentals — To pay the lessor in advance on the first day of the month in which the lease issues a rental at the following rates:
>
> (a) If the lands are wholly outside the known geologic structure of a producing oil or gas field:
>
> (1) For the first lease year, a rental of 50 cents per acre.
>
> (2) For the second and third lease years, no rental.
>
> (3) For the fourth and fifth years, 25 cents per acre.
>
> (4) For the sixth and each succeeding year, 50 cents per acre.
>
> (b) On leases wholly or partly within the geologic structure of a producing oil or gas field:
>
> (1) Beginning with the first lease year after 30 days' notice that all or part of the land is included in such a structure and for each year thereafter, prior to a discovery of oil or gas on the lands herein, $1 per acre.
>
> (2) On the lands committed to an approved Co-operative or unit plan which includes

a well capable of producing oil or gas and contains a general provision for allocation of production, for the lands not within the participating area an annual rental of 50 cents per acre for the first and each succeeding lease year following discovery.

Minimum royalty—To pay the lessor in lieu of rental at the expiration of each lease year after discovery a minimum royalty of $1 per acre or, if there is production, the difference between the actual royalty paid during the year and the prescribed minimum royalty of $1 per acre, provided that on unitized leases, the minimum royalty shall be payable only on the participating acreage.

Royalty on production—To pay the lessor 12½ per cent royalty on the production removed or sold from the leased lands.

The average production per well per day for oil and for gas shall be determined pursuant to 30 CFR, Part 221, 'Oil and Gas Operating Regulations'.

In determining the amount or value of gas and liquid products produced, the amount or value shall be net after an allowance for the cost of manufacture. The allowance for cost of manufacture may exceed two-thirds of the amount or value of any product only on approval by the Secretary of the Interior."

The payments in question in this case are only those specified in subparagraph (a) (1) of Schedule "A" above; at no place, whether the same be the provisions of the Act of February 25, 1920, as amended by the Act of August 8, 1946, or the instant leases, can it be said that such payments were called royalties or anything other than "rents" or "rentals".

SUMMARY OF ARGUMENT

The payments here involved were intended by Congress to be and were, in fact, true rentals, i.e., one of a series or periodic payments made for the use of leased property for a specified period of time. As such they were deductible under Section 23 (a) (1) (A) of the Internal Revenue Code of 1939 if paid by Respondents pursuant to a trade or business, or under Section 23 (a) (2) if not paid by Respondents pursuant to a trade or business.

ARGUMENT

POINT I.

ANALYSIS OF PETITIONER'S ARGUMENT

Petitioner contends that the payments made by Respondents for the first year of the lease term of certain Federal oil and gas leases and denominated "rentals" are, in fact, non-deductible, capital outlays. Petitioner in his brief advances two arguments:

(1) That the payments here involved were made for the acquisition of a so-called "economic interest" and hence must be capitalized;

(2) Since by virtue of these leases Respondents had an "economic interest" in the oil and gas in place, entitling them to a depletion allowance, all payments (except delay rentals) made by the Lessee-Respondents to the United States must perforce be capitalized.

POINT II.

PURSUANT TO THE INTENTION OF THE PARTIES THE PAYMENTS HERE INVOLVED WERE MADE FOR THE USE OF THE LEASED PREMISES FOR A SPECIFIED PERIOD OF TIME AND WERE TRUE RENTALS.

Petitioner argues that the payments here involved were made for the acquisition of an "economic interest" in oil and gas in place. The term "economic interest" was developed, as is later discussed, in connection with the allowance for depletion, i.e., a person who had this "economic interest" was entitled to the depletion deduction.

Admittedly, as lessees of Federal oil and gas leases Respondents would have the right to take depletion on production and thus had an "economic interest". The question, however, is whether the payment here involved was made as the purchase price for this "economic interest", i.e., the lease, and thus is what is known as bonus or advance royalty, or whether the payment is, in fact, true rental.

To determine the true nature and purpose of the payment, the meaning of the word "rental" found in Section 23 (a) (1) (A), Internal Revenue Code, 1939, must be determined. It is also essential to know whether Congress intended the payments here involved and denominated "rental" to be, in fact, rental and to serve the function of rental or whether the intent was that it be "bonus".

First, what is meant by "rental" as the word is employed in Section 23 (a) (1) (A), supra, and what is "bonus", sometimes referred to as "advance royalty"? Both concepts are, of course, employed in non-mineral as well as in mineral leases.

The meaning of the word "rental", employed in the rental deduction provisions of the Act of 1916, which provisions have been re-enacted without substantial change as Section 23 (a) (1) (A), has been considered by the Supreme Court of the United States. That Court found the meaning to be:

> "The term 'rentals' since there is nothing to indicate the contrary, must be taken in its usual and ordinary sense, that is, as *implying a fixed sum,* or property amounting to a fixed sum, *to be paid at stated times for the use of property.*" (Emphasis supplied.) *Duffy v. Central Railroad of New Jersey,* 268 U.S. 55, 45 S. Ct. 429 at 431 (1924).

Bonus, in contrast to rent, is a single non-recurring payment which is paid for the lease. It is consideration for the *entire* lease and, therefore, as cost of the lease, must be capitalized.

In a non-mineral lease, bonus is amortized over the term of the lease, i.e., prorated against income for the operation of the leased premises as that income accrues over the years. In *Galatoire Brothers v. Lines, Collector of Internal Revenue,* 23 F. 2d 676 (5th Cir. 1928), the lessee paid the landlord a sum in addition to rent, and the Court held that that sum was bonus and that, although the rent was currently deductible, the bonus must be capitalized and amortized. See *Kekaha Sugar Company, Ltd. v. Burnet,* 50 F. 2d 322 (D.C. Cir. 1931) and *J. Alland & Bro. Inc. v. United States,* 28 F. 2d 792 (D.C. Mass. 1928) where the taxpayer paid a lessee a sum for an assignment of the leasehold interest, in addition to agreeing to pay the rent, and the Court held that said sum was bonus and must be capitalized and amortized. See also *Reg. 111, Section* 29.23 (a)-10.

In a mineral lease, the single, non-recurring payment paid for the entire lease and for no specified portion of the lease term, denominated bonus, is considered as advance royalty. The bonus is considered to be a payment in advance for oil and gas to be removed.

> "On the other hand, royalties, including bonus, are not paid for time but for oil and gas taken out, and represent an actual removal and disposition of the contents of the soil." *Commissioner v. Wilson,* 76 F. 2d 766. (5th Cir. 1935).
>
> "A bonus is not proceeds from the sale of property, but payment in advance for oil and gas to be extracted, and is therefore taxable income." *Herring v. Commissioner,* 293 U.S. 322, 55 S. Ct. 179 (1934).

Bonus is ordinary income to the recipient subject to the depletion deduction. *Burnet v. Harmel,* 287 U.S. 103, 53 S. Ct. 74 (1932); *Murphy Oil Company v. Burnet,* 287 U.S. 299, 53 S. Ct. 161 (1932); *Palmer v. Bender,* 287 U.S. 551, 53 S. Ct. 225 (1933); *Herring v. Commissioner,* supra. The payer of the bonus, since the bonus is considered advance royalty, must recover the bonus through depletion as production income accrues. *Sunray Oil Company v. Commissioner,* 147 F. 2d 692 (10th Cir. 1945); *Canadian River Gas Co. v. Higgins,* 151 F. 2d 954 (2nd Cir. 1945); *Quintana Petroleum Co. v. Commissioner,* 143 F. 2d 588 (5th Cir. 1944); *Baton Coal Co. v. Commissioner,* 51 F. 2d 469 (3rd Cir. 1931). See also *Reg. 111, Section* 29.23 (m)-10 (A).

From an examination of the above mentioned cases, it can be seen that the essential difference between rental and bonus is that rental is a periodic payment paid to hold

property for specified portions of the lease term, whereas bonus is a single, non-recurring payment paid for the lease as a whole.

With this in mind, it may be helpful to examine the successive acts of Congress under which the public domain was leased for oil and gas purposes. It is believed that this examination will aid in the determination of whether the rental herein involved was, in fact, one of a series of periodic payments made at stated times for the use of property or was a single payment made for the "economic interest", i.e., the lease. If the former, it should be deductible as paid; whereas if it is the latter it should be recouped through depletion over the lease term.

Prior to 1920, oil and gas prospecting on the public domain was authorized only under the Act of May 10, 1872 (17 Stat. 91), as amended by the Act of 1897 (29 Stat. 526). These Acts, being primarily designed for the mining industry, were not adaptable to the needs of oil and gas exploration, development and production.

Therefore, in 1920, Congress enacted the first oil and gas leasing act (Leasing Act of February 25, 1920, 41 Stat. 437). Under this Act an applicant received a two-year prospecting permit and if, prior to the expiration of this permit, he made discovery of a valuable deposit of oil or gas, he had the right to lease one-fourth of the acreage covered by the permit at a five per cent royalty. He further had a preferential right to lease the balance of the acreage covered by the permit at a royalty of not less than twelve and

one-half per cent. *Section 14, Leasing Act of February 25, 1920,* 41 Stat. 437. The Act further provided that all lands within a "known geological structure of a producing oil or gas field" and not covered by a prospecting permit would be leased by competitive bidding "upon payment by the lessee of such *bonus* as may be accepted and of such royalty as may be fixed in the lease". *Section 17, Leasing Act of February 25, 1920,* supra.

This method of oil and gas development of the public domain proved unsatisfactory and, therefore, in 1935, Congress radically revised the Leasing Act of 1920 by enacting an amendatory act, Act of August 21, 1935, 49 Stat. 674.

Under the 1935 Act, prospecting permits were abolished except for those then existing and those filed ninety days after the effective date of the Act. For the prospecting permit system, there was substituted a procedure by which leases on lands not within a known geological structure of a producing oil and gas field were granted to the first qualified applicant at a royalty of twelve and one-half per cent where production did not exceed fifty (50) barrels per well per day and of not less than twelve and one-half per cent when production exceeded that figure. On the other hand, the issuance of leases on lands within a known geological structure were "conditioned upon the payment by the lessee of such *bonus* as may be accepted" and of such royalty as may be fixed. On all leases, whether within or without a known geological structure, there was required the payment of a rental of "not less than twenty-five cents per acre". *Section 17, Leasing Act of February 25, 1920,* supra, as amended by *Act of August 21, 1935,* supra.

In 1940, (Act of July 8, 1940, 54 Stat. 742), Congress amended the 1935 Act by waiving advance rentals for the second and third years of the lease term.

In 1946, Congress again re-examined the entire procedure for leasing public domain lands for oil and gas purposes and finding that the existing system did not sufficiently encourage exploration on the public domain, enacted, after prolonged hearings, the Act of August 8, 1946 (60 Stat. 950, 30 U.S.C. 181 et seq. (Supp. 1946)). In that Act the number of acres which any one person could hold under oil and gas lease was increased to 14,360 acres in any one state, the royalty on non-competitive leases, i.e., leases issued without the payment of a bonus, was limited to twelve and one-half per cent and for the first time citizens were granted the privilege of holding, in addition to their lease acreage, acreage under option not to exceed 100,000 acres in any one state. The Act further provided for the payment of advance rentals annually on all leases, whether competitive or non-competitive, but maintained the principle of the amendatory Act of July 8, 1940, supra, by waiving rentals for the second and third years of the lease term.

The relevant portions of the 1946 Act are set forth below:

> *"When the lands to be leased are within any known geological structure of a producing oil or gas field, they shall be leased to the highest responsible qualified bidder by competitive bidding* under general regulations, in units of not exceeding six hundred and forty acres, which shall be as nearly compact in form as possible *upon the payment by the lessee of such bonus as may be accepted by the*

> *Secretary* and of such royalty as may be fixed in the lease which shall not be less than 12½ per centum in amount or value of the production removed or sold from the lease. *When the lands to be leased are not within any known geological structure* of a producing oil or gas field, *the person first making application* for the lease who is qualified to hold a lease under this Act *shall be entitled to a lease of such lands without competitive bidding.* Such leases shall be conditioned upon the payment by the lessee of a royalty of 12½ per centum in amount or value of the production removed or sold from the lease . . . *All leases issued under this section shall be conditioned upon the payment by the lessee in advance of a rental of not less than 25 cents per acre per annum.* A minimum royalty of $1.00 per acre in lieu of rental shall be payable at the expiration of each lease year beginning on or after a discovery of oil or gas in paying quantities on the lands leased; PROVIDED, that in the case of lands not within any known geological structure of a producing oil or gas field, the rentals for the second and third lease years shall be waived unless a valuable deposit of oil or gas be sooner discovered." (Emphasis supplied.) *Section 3, Act of August 8, 1946,* 60 Stat. 950, 30 U.S.C. 226 (Supp. 1946).

Thus, both in the 1935 and in the 1946 Acts, Congress sharply distinguished between leases on lands within a known geological structure and those not within a known geological structure. To obtain a lease on the former, payment of a bonus was required; whereas, as to the latter, leases were issued to the first qualified applicant, no bonus being required. Nevertheless, on leases of both types, and thus irrespective of whether a bonus was paid or not, Congress required the payment, annually and in advance, of a rental of not less than 25 cents an acre.

A study of the Leasing Acts of 1935 and of 1946 reveals that Congress had clearly in mind the distinction between bonus and rental, purposefully determining to sell leases, i.e., charge a bonus, on lands within a known structure. Equally clearly, Congress determined not to "sell" leases on unproven lands but determined that every qualified citizen should have the right to obtain a lease on such lands provided he makes the first application. On both types of leases, Congress legislated that the holding charge of not less than 25 cents per acre per year should be paid.

The impression created from a reading of the Leasing Act as to Congressional intent is amply borne out by a study of the history of each of the Acts. Furthermore, it is eminently reasonable that Congress should have distinguished between the two types of leases. It is highly logical that when dealing with proven lands Congress would require a payment in advance for the oil and gas to be extracted, i.e., a bonus payment. Such a payment would obviously be advance royalty and subject to capitalization. It is equally logical that Congress would require no such payment when dealing with wildcat lands, but should grant leases on such land to the first qualified applicant who paid the filing fee.

The failure to "sell" and require competitive bids and bonus payments on lands not within a known geological structure did not come about without argument. The Department of the Interior strenuously argued that all oil and gas leases should be sold and that a bonus should be paid for all. *Sen. Rep. No. 1158, Committee on Public Lands and Surveys, 74th Congress, 1st Session,* Page 3, contains

a significant letter from Harold L. Ickes, then Secretary of the Interior, dated February 26, 1935, and addressed to the Committee Chairman.

In this letter, Mr. Ickes reviews the general custom of leasing private and public lands:

> "Under the general custom of leasing lands for the discovery and production of oil and gas from the early days of the industry, the lessee pays the lessor a bonus in cash for the privilege of leasing and a percentage royalty on production obtained. The amount of bonus and royalty paid for private lands has been a matter for trading between the interested parties. For public lands, the percentage royalty has most generally been fixed by law or regulation and the bonus determined by competitive bidding. In most cases a royalty of 12½ per cent, plus a cash bonus in dollars per acre, has been the result, though royalties of 16⅔ per cent are not uncommon and higher royalties have been obtained under exceptional conditions. Royalties of less than 12½ per cent have been practically unknown in the industry."

Mr. Ickes protested that the 1920 Act departed from this established custom as to oil and gas leasing, and that the provision of the 1935 Act granting leases to first qualified applicants on lands not within a known geological structure perpetuated this departure from established custom and was subversive to public interest in that no bonus was charged for this type of lease. He argued strenuously that a bonus should be charged on all leases and the provision in the then proposed legislation permitting leases on lands not within a known geological structure to issue, without bonus payments, to first qualified applicants, be eliminated.

See also *H. R. Rep. No. 1101, Committee on Public Lands, 74th Congress, First Session* (1935) and *H.R. Rep. No. 1747, Committee on Public Lands, 74th Congress, First Session* (1935) wherein the same letter is published.

Despite this vigorous protest by the Department of the Interior, Congress refused to sell, i.e., charge a bonus on, leases of lands not within a known geological structure, but authorized their issuance on a first-come first-served basis.

In 1946, when Congress was again considering amending the Leasing Act, the same objection was raised by the Department of the Interior. Furthermore, the Department apparently felt that the proposed legislation restricted the area of competitive bidding even more than did the 1935 Act. We cannot see that such is the case; however, it is the attitude of the Department of the Interior which is important. See letter dated March 15, 1946, from Acting Secretary of the Interior, Oscar L. Chapman, to the Chairman of the Committee on Public Lands and Surveys, United States Senate, *Sen. Rep. No. 1392, 79th Congress, Second Session* (1946), Page 6.

A similar protest was made by the Secretary of the Interior, J. A. Krug, to the Chairman of the Committee on Public Lands, House of Representatives. See *H. R. Rep. No. 2446, 79th Congress, Second Session* (1946), Page 5. Furthermore, the Secretary protested even more strenuously to the Committee on Public Lands and Surveys at hearings held at Washington, D.C., May 7, 8 and 9, 1946. At these hearings, the Secretary stated:

"The Government would be prevented by this provision from realizing a revenue from many areas which are reasonably believed to contain oil and gas but which have not been proved to be productive.

Since neither this Department nor the Department of Agriculture, as a rule, has experienced difficulty in finding bidders for any land offered for lease, it is apparent that there is no necessity for such a restriction in order to promote prospecting.

As a matter of fact, I understand that the Department of Agriculture feels that this Department has been too conservative in offering prospective lands for bidding, and that it believes leases should be sold rather than issued upon non-competitive applications, in any area where an active competitive interest is found to exist.

There is merit in this assumption from the standpoint, at least of revenue for the people of the West, who are the ultimate beneficiaries of the fiscal provisions of the Mineral Leasing Act.

The practice of offering unproven lands for competitive bidding is followed by many states with respect to some or all of their own lands.

New Mexico, in particular, appears to have found it profitable to do so, as it collected over $1,000,000 bonuses during the fiscal year 1944.

Most private landowners also obtain some bonus for a lease. In any event, there can be no substantial argument against the sale of leases on lands reasonably believed to contain oil and gas, whether that belief is based on their relation to known oil lands or as the result of geologic inference. *Hearings before the Committee on Public Lands and Surveys, on S. 1236, 79th Congress, Second Session* (1946), Page 238."

The same type of protest was made by Mr. J. D. Wolfsohn, Assistant Commissioner of the General Land Office, Department of the Interior, who stated to the Committee on Public Lands and Surveys as follows:

> *"I see no reason why the United States should make a free grant of the right to lease land reasonably believed to contain oil or gas which a state or a private owner would be able to sell for a substantial sum." Hearings before the Committee on Public Lands and Surveys on S. 1236, 79th Congress, Second Session* (1946). (Page 254).

An early draft of the 1946 Act provided for the transfer of Department of Agriculture lands to the Department of the Interior for oil and gas leasing purposes. The Secretary of Agriculture, Clinton P. Anderson, addressed a letter dated March 8, 1946, to the Chairman of the Committee on Public Lands and Surveys, in which the Secretary of Agriculture expressed concern as to the loss of revenue which would result from leasing lands not within a known geological structure, without requiring a bonus. He stated as follows:

> "Aside from the question of administrative coordination, S. 1236 presents an important question of public policy, namely, the procedure to be followed in disposing of oil and gas privileges in lands which are not within the known geologic structure of a producing oil and gas field. Under the procedures of the Federal Mineral Leasing Act, such lands are subject to the principle of first in time, first in right, the first qualified applicant establishing a preference or priority under which the payment of a filing fee is all that is required, no competitive bid or bonus being necessary. The oil and gas regulations of this Department are based on a different princi-

> ple, namely, that if an active competitive interest is found to exist within a particular territory the oil and gas privileges will be disposed of only by competitive bid even though the lands are not within the known geologic structure of a producing field." *Reports submitted to Committee on Public Lands and Surveys by the Department of the Interior and the Department of Agriculture, 79th Congress, Second Session* (1946) (Committee Print).

The Secretary then demonstrated the loss of revenue which would have been sustained had the 1935 Act applied to agricultural lands and the Department of Agriculture had been unable to charge bonuses except when lands were within a known geological structure.

Apparently as a result of this protest, agricultural lands were eliminated from the bill. Nevertheless, the protests of the Department of the Interior were in vain and the bill was enacted as proposed, resulting only in the selling of leases on lands within a known geological structure.

It would, therefore, appear that the purpose of the bill as stated by Senator O'Mahoney prevailed.

> "The bill is designed to stimulate the discovery of new petroleum reserves; to promote the development of oil and gas on some 300,000 square miles of potential oil lands of the public domain; to grant incentives which will bear as their rewards American leadership in industry and world affairs." *Sen. Rep. No. 1392, 79th Congress, Second Session* (1946), Page 1.

As a further indication that Congress was fully aware of the difference between bonus and rental, it is interesting

to note that Acting Secretary of the Interior, Oscar L. Chapman, in his letter previously mentioned, protested the waiver of second and third year rentals on the grounds that no one should be permitted to "hold public land rent free". He stated as follows:

> "It is recommended that the Act (Act of July 8, 1940) be repealed and that the provision contained in S. 1236 be deleted. There is no reason for permitting a lessee to hold public land *rent free* without development. The relatively low rate of rental of 50 cents per acre for the first year and 25 cents an acre for each subsequent lease year charged for undeveloped federal lands is sufficiently low to encourage the acquisition of leases without waiver of the second and third year rentals." *Sen. Rep. No. 1392, 79th Congress, Second Session* (1946), Page 10.

In summary, Congress was clearly aware of the difference between bonus and rental and purposefully refused to sell leases, i.e., charge a bonus, on leases not within a known geological structure. Congress did, however, charge rentals on all leases, whether within or without a known geological structure, but explicitly waived rentals for the second and third years on non-competitive leases.

The Leasing Act and the legislative history of the Act clearly shows that Congress intended lessees to purchase the "economic interest" granted by a lease where the lands are within a known geological structure, payment of a bonus being provided. On the other hand, where the lands are not within a known geological structure, Congress intended as a matter of policy to make a "free grant" of the lease (economic interest) to the first qualified applicant. Congress required that annual rentals be paid on both types of leases.

In view of the clear understanding of Congress of the difference between bonus and rental and the different function of each, and further, in view of the specific and considered Congressional refusal to charge a bonus on the type of lease herein involved, Respondents respectfully submit that the statement of Petitioner that the rentals were paid *for* the "economic interest", i.e., as purchase price of the lease, is erroneous and that Petitioner's effort to convert rental into bonus or advance royalty should fail.

Petitioner argues that the lease form supports his contention. He states that Section 1 grants the lease "in consideration of rents and royalties to be paid and the conditions and covenants to be observed." Obviously, all leases of whatsoever nature are granted in consideration of the rents and other covenants to be observed. This does not mean, however, that rents are not rents and must be capitalized. Nor do other provisions of the lease discussed by Petitioner seem significant, i.e., that the lessee has the right to use the surface of the lands, that second and third year rentals are waived, and that a lessee could assign or sublease.

Petitioner devotes a large portion of his brief to the proposition that a bonus, i.e., a payment made for the "economic interest", must be capitalized, and recouped through depletion deductions as oil and gas is produced, or if no oil and gas is produced, then as a deduction in the year of surrender of the lease. Respondents agree with this statement. Unquestionably, where the payment is a bonus the consequences mentioned above follow. This is the holding of

Sunray Oil Co. v. Commissioner, supra, and *Canadian River Gas Co. v. Higgins,* supra, both of which are discussed at great length by Petitioner in his brief. It is also the holding of *Quintana Petroleum Co. v. Commissioner,* supra, and *Baton Coal Co. v. Commissioner,* supra, cited in Petitioner's brief; it is the substance of *Regulation 111, Section* 29.23 (m)-1 and (m)-10 to the Internal Revenue Code, mentioned in Petitioner's brief. To the extent that *Jefferson Lake Sulphur Co. v. Lambert,* (E.D. La.), decided June 29, 1955 (1955 P-H, Par. 72, 863), conflicts with the above decisions we concur with Petitioner that it is wrongly decided.

All this, however, begs the question. Obviously *if* the payment here involved is for the acquisition of the leasehold and thus is a bonus, it must be capitalized. The essential question to be decided is what is the true nature of the payment here involved; Petitioner never attempts to answer this question, but assumes that the payments were bonuses.

Petitioner states that the name given the payment should not be controlling and cites *Southwestern Hotel Co. v. U.S.,* 115 F. 2d 686 (1940), where the Fifth Circuit, in discussing whether certain payments made pursuant to a mineral lease should be capitalized correctly refused to allow the name given to the payment to control, stating:

> "If the name controlled the fact, this tax could be avoided by the ignorant by chance misnomer or by the learned by intentional misnomer." (At page 688).

Respondents concur that the name given the payment should not control and that "the ignorant by chance misnomer or . . . the learned by intentional misnomer" should not avoid a tax. However, Congress, when it employed the word "rental" was not ignorant of the distinction between rental and bonus, but was extremely well informed concerning the substance and true nature and meaning of the terms. The legislative history of the Leasing Act shows that Congress employed the term "rental" because the term expressed the true substance of what Congress intended the payment to be. Furthermore, Respondents cannot believe that Petitioner contends that Congress was guilty of "an intentional misnomer".

POINT III.

ESTABLISHED PRECEDENTS SUPPORT THE DECISION OF THE COURT BELOW.

In addition to the foregoing, the Petitioner appears to argue that since lessees under Federal oil and gas leases have an "economic interest" in the oil and gas in place, all payments by the lessee to the lessor (except delay rentals) must be capitalized.

The "economic interest" concept was developed to assist in determining when a taxpayer was entitled to the depletion allowance on production royalties or advance royalties. *Burnet v. Harmel,* supra; *Murphy Oil Co. v. Burnet,* supra; *Palmer v. Bender,* supra; *Herring v. Commissioner,* supra; *Burton-Sutton Oil Co. v. Commissioner,* 328 U.S. 25, 90 L. Ed. 1062 (1945). As stated in the *Burton-Sutton* case and as quoted by Petitioner in his brief a taxpayer has an "economic interest" in oil and gas in place when his "possibility of profit" depends "solely upon the

extraction and sale of the oil". If a taxpayer has this economic interest, he is then entitled to the depletion allowance.

There is no question but that the lessee of a Federal oil and gas lease is entitled to depletion on production from that lease and has the necessary "economic interest" to support the depletion deduction. It is a non sequitur, however, to say that because a lessee has this economic interest, all payments which he makes to the lessor, except so-called "delay" rentals, must be capitalized.

Obviously no such rule has been adopted by the courts. The courts have examined each payment made by a lessee to a lessor to determine its true nature, i.e., whether it be truly a rental and thus deductible or bonus and thus non-deductible.

In determining the true nature of the payment, the lease agreement, the name given the payment and the intent of the parties are of first importance. In *Continental Oil Co.,* 36 B.T.A. 693 (1937), the lease agreement provided for a five year lease extension upon the payment annually of a specified sum. The court, relying on the expressed intent of the parties, held as follows:

> "It appears to us that parties to the contract plainly indicated therein their intention that the advance yearly payments for the annual extensions of the leases should not be considered as payments for mineral until production began and that the payment in question here was made for rental 'without operations or production' merely to hold the property until the lessee should bring it into production." (At Page 698).

Similarly in *Houston Farms Development Co. v. United States,* 131 F. 2d 577 (5th Cir., 1942), the court looked to the agreement to determine the nature of the payment and stated:

> "Whether the $25,000 paid was for mere delay, rather than for oil expected to be produced, is best ascertained from the agreement of the parties." (At Page 579).

Where the expressed intent of the parties is not in accord with their true intent as observed through the indicia of the payment, the courts have ignored the expressed intent. For instance, in *Charles H. Merillat,* 9 B.T.A. 813 (1927), a payment called "advance royalties" was held, in fact, to be rental and, therefore, deductible. On the other hand, in *James Lewis Caldwell McFaddin,* 2 T.C. 395 (1943), a payment called "rental" was held to be minimum royalty.

In *Alice G. K. Kleberg,* 43 B.T.A. 277 (1941), the agreement provided for annual rentals of $3,957.07 but further provided that they be discounted to present value and paid one-half in 1933 and one-half in 1934. The Court viewed the transaction as follows:

> "Petitioner in consideration of the payment of $49,313.83 payable to her in two installments plus a reserve oil and gas royalty of one-eighth (⅛) of the oil and gas to be produced leased her 30,439 acre tract for a period of twenty years, and thereafter as to any developed structures for so long as production is had from such structures. Under this state of facts, we hold that the $24,656.92 received by Petitioner in 1933, was a bonus in the nature of advance royalties and that Petitioner is entitled to percentage depletion thereon." (At Page 294).

Petitioner concedes that a "delay" rental may be deducted. See Petitioner's brief, pages 9 and 10. The typical delay rental, in the words of Petitioner, secures "for the payor the right to hold the leases for the succeeding year or years without the necessity of drilling wells or making further payments except royalties on the minerals produced".

Petitioner must consider delay rentals not to be rent. Otherwise he could not concede their deductibility. The courts, however, have held these delay rentals deductible, not because they are different from rent, but because, in fact, they are true rents. In *Commissioner v. Wilson,* supra, the Court stated:

> "The 'delay rentals' on oil and gas leases are rents within the rule just announced. They accrue by the mere lapse of time like any other rent. They do not depend on the finding or production of oil or gas and do not exhaust the substance of the land. While having some likeness to a bonus payment which is held to be advance royalty, *Murphy Oil Co. v. Burnet,* 287 U.S. 299, 53 S. Ct. 161, 77 L. Ed. 318; *Burnet, Commissioner v. Harmel,* 287 U.S. 103, 53 S. Ct. 74, 77 L. Ed. 199, the delay rental is not paid directly or indirectly for oil to be produced, but is for additional time in which to utilize the land. We hold it to be rent. *Caruthers v. Leonard,* (Tex. Comm. App.) 254 S.W. 779, 783; *Sneed v. Commissioner,* 30 B.T.A. 1121.
>
> "On the other hand, royalties, including bonus, are not paid for time but for oil and gas taken out, and represent an actual removal and disposition of the contents of the soil." (At Page 769).

This language was quoted with approval in *J. T. Sneed, Jr.,* 33 B.T.A. 478, 483 (1935). See also *I.T.* 3401, 1940-2,

C.B. 199, where Petitioner himself states "there is no distinction between the term 'rent' in the sense that that term ordinarily is used and 'delay rentals'."

Furthermore, rentals which have been held to be deductible are by no means confined to delay rentals. In *Houston Farms Development Co. v. United States,* supra, the taxpayer took 5,000 acres of land under a so-called selection lease. The lease agreement provided that the lease would terminate within fifty-five days "unless on or before that date, lessee, at its election, pays to lessor . . . $12.50 per acre for all or such part of the land as lessee desires to retain." At the end of each successive year thereafter the lease agreement provided for the payment of a typical "delay rental" of $5.00 an acre. Prior to the end of the fifty-five days, the lessee selected certain land and paid at the rate of $12.50 per acre. The Court found the payment to be "in the nature of rent" and thus deductible.

In the *Merillat* case, supra, the lessee, among other expenditures, paid a sum on an oil and gas lease pursuant to a lease provision which stated that "until a producing well is completed on said premises the lessee shall pay . . . as advance royalty . . . fifteen cents per acre per annum in advance for the first and second years, thirty cents per acre per annum in advance for the third and fourth years". The Court there held the payments to be rental and thus deductible.

In *Continental Oil Co.*, supra, where annual cash payments were to be made until production was obtained, the Court found that the payment was made "merely to hold the property until the lessee should bring it into production". It, therefore, was rental.

The above cases did not involve "delay" rentals; however, the courts found the payments to be rentals and, therefore permitted the deduction. Thus the conclusion of Petitioner, that prior to *Olen F. Featherstone,* 22 T.C. 763 (1954) and *United States v. Dougan,* 214 F. 2d 511 (10th Cir. 1954) only technical delay rentals were deductible, is erroneous.

The mechanical rule argued for by Petitioner, i.e., that all payments except delay rentals made by a mineral lessee to a mineral lessor must be capitalized, leads to absurb situations. For instance, under the Leasing Act, Congress provided that leases on known geological structures should be sold and a bonus paid therefor, but that leases on other lands should be issued to the first qualified applicant. Congress required payment of annual rentals on both types of lease.

Petitioner would have lessees capitalize the rental as well as the bonus apparently on the grounds that the nature and purpose of both payments are identical. The absurdity of this argument is readily apparent. Congress recognized a difference between bonus and rental, and over the objection of the Department of the Interior, provided that leases on lands outside known geological structures should not be sold but that a free grant of such leases should be made to the first qualified applicant. Congress recognized that the rental was a charge which held land for specified periods. As previously discussed, the waiver of the rental for the second and third year of the lease term was strenuously but unsuccessfully objected to by the Department of the Interior on the grounds that no Federal lands should be held "rent free".

If Petitioner's argument should prevail a similar situation would arise in the instance of certain leases on state lands. For instance, in New Mexico, the statutes (New Mexico Statutes Annotated 1953, Title 7, Chapter 11, Sections 9 and 10) confer on the Commissioner of Public Lands the authority to sell leases, i.e., charge bonuses, in areas of his choosing. If Petitioner's argument should prevail, the bonus required to be paid by the Commissioner on certain lands and the annual rental which the statute provides must be paid on all lands would be treated as one and the same type of payment.

Petitioner relies on *Jefferson Lake Sulphur Co. v. Lambert,* supra, the holding of which he states is contrary to the *Featherstone* and *Dougan* cases. There, the lessee of a mineral lease agreed to pay $300,000. This $300,000 was payable in quarterly installments of $7,500 each during the years of a ten year primary term. The taxpayer argued that these installment payments were deductible as rentals under Section 23 (a) (1) (A), Internal Revenue Code, 1939. The Court said that the taxpayer's position was supported by the *Dougan* and *Featherstone* cases, supra, but indicated it felt the cases were wrongly decided.

The factual situations in the *Dougan* and the *Featherstone* cases are entirely different from the factual situation in the *Jefferson Lake* case, where the payments in question were installments of a $300,000 bonus. Therefore, Respondents submit that in the *Jefferson Lake* case a true bonus was involved, and the case cannot be used as authority contra to the *Dougan* and *Featherstone* cases.

The logical difficulty in attempting to confine true rentals to "delay" rentals was well stated by the Court in the *Featherstone* case:

". . . Respondent would have us distinguish between delay rentals and the first year payments involved in this proceeding. It is our opinion, however, that the two differently styled payments are nevertheless in substance the same. Both are fixed sums paid in advance to secure for the payor the right to hold the lease for the succeeding year or designated period without the necessity of drilling wells or making further payments, except royalties on the mineral produced. Neither payment is deemed compensation for the mineral extracted from the soil, although, in the event of production, the first-year payment may be credited against current royalties. But that would be true also of payments for subsequent lease years, which payments respondent here concedes are deductible. Moreover, even if it is true, as respondent alleges, that a lessee acquires an economic interest in oil or gas in place upon making a first-year payment, it is, in our opinion, equally true that a lessee retains a similar interest on paying a delay rental. It would seem then that the delay rentals possess no fewer attributes of a 'capital investment' than do the annual payments in the case at bar. Yet for tax purposes it is undisputed that delay rentals are deductible by the payor and non-depletable by the payee . . ."

The Tenth Circuit in the *Dougan* case, supra, held that first year rentals paid on Federal oil and gas leases were true rentals and in support of its holding, pointed to well established authorities.

"The payments here were made as a condition for the continued use and possession of a defeasible interest in the minerals quite as much as advance payments for annual extension of leases in *Continental Oil Co. v. Commissioner,* 36 B.T.A. 693, or the delay rentals in *Sneed v. Commissioner,* 33 B.T.A. 478 and *Houston Farms Development Co. v. United States,* supra. In all of these cases the lessors un-

successfully sought to treat the receipt of payments as in the nature of depletable bonuses or advance royalties. In *Merillat v. Commissioner,* 9 B.T.A. 813, 'advance royalties and rentals' paid for the extension of a departmental oil and gas lease were held to be deductible expenses in the year in which they were paid." (At page 514).

POINT IV

THE RESPONDENTS WERE IN A TRADE OR BUSINESS INCIDENT TO THE OIL AND GAS LEASES AND THE RENTALS WERE DEDUCTIBLE UNDER SECTION 23 (a) (1) (A), BUT EVEN IF IT BE ASSUMED THAT THEY WERE NOT ENGAGED IN SUCH TRADE OR BUSINESS, THE RENTAL PAYMENTS ARE DEDUCTIBLE UNDER SECTION 23 (a) (2) OF THE INTERNAL REVENUE CODE OF 1939.

(a) Said rentals were paid for the purposes of Respondents' trade or business.

At pages 30-31 and 33-35 of the brief, the Petitioner presents an argument that the payments in question may not be deductible under Section 23 (a) (1) (A) of the Internal Revenue Code because, "At best, in so far as the record shows, the taxpayer, together with his partners, was engaged solely in a series of a few isolated transactions whereby he made investments in oil and gas leases, but this, needless to say, did not constitute carrying on a trade or business within the rule of the *Higgins* case, supra".

The aforesaid arguments on the part of the Petitioner are purely technical in nature and confuse the singular issue before the Court. The evidence is uncontroverted that the Respondents are and were, during the years herein involved, husband and wife and that the Respondent Robert H. Miller is a geologist and is and has been engaged

in various enterprises in the oil and gas field (R.24). These facts are admitted by the Petitioner at page 3 of his brief.

As concerns the requirements of Section 23 (a) (1) (A) that the expenses be paid or incurred during the taxable year in carrying on any "trade or business", reference is made to the following quotation in 4 Mertens, *Law of Federal Income Taxation* (1942) at page 310:

> "It has been said that carrying on a trade or business involves 'holding one's self out to others as engaged in the selling of goods or services'." *Deputy, et al Administrators v. Pierre S. Du Pont,* 308 U.S. 488 (1940), 84 L. Ed. 416, 60 S. Ct. 363. "In order that the taxpayer's activities may be characterized as trade or business it is not necessary that the taxpayer have a reasonable expectation of profit from the conduct of the enterprise. It is necessary, however, that the enterprise be initiated and conducted in good faith by the taxpayer with the intention of making a profit or of producing income. The factor of profit is only significant in so far as it affords a means of distinguishing between an enterprise conducted as a business and as a hobby.
>
> The term 'business' is at least broader than the lay concept, in that it includes income from the professions and the arts as well as from ordinary commercial activities . . ."

Apparently the Petitioner is making the contention that deduction should be denied under Section 23 (a) (1) (A) because he claims the Respondents obtained an "equity" in the leases. It is submitted that the term "equity" as used in Section 23 (a) (1) (A) positively does not mean the interest ordinarily obtained by a lessee in securing a lease. Equity, as used in Section 23 (a) (1) (A) means a

beneficial interest or title in the property substantially equivalent to legal title. Typical applications of the meaning of the words "title" and "equity" in Section 23 (a) (1) (A) are involved in the numerous taxation cases dealing with purchases of chattels which are disguised as leases and wherein the purchase payments are denominated rentals, but are in fact deferred installment payments to acquire title.

For example, reference is made to the case of *Benton v. Commissioner,* 197 F. 2d 745 (5th Cir., 1952), wherein the court stated:

> "If the parties in good faith actually intended to enter into a lease contract, then the taxpayer, up until the time that he exercised his option to purchase, acquired no title to or equity in the property. For the Commissioner and the Tax Court to decide solely by the application of an objective economic test that the taxpayer had an equity in the property, effectively begs the question to be decided, namely whether what was in form a lease was in substance and according to the real intention of the parties a conditional sale contract."

See also *Judson Mills,* 11 T. C. 25, wherein the taxpayer, a textile producer, acquired new mill machinery under agreements called leases whereby it was required to make fixed monthly payments called rentals to the machinery manufacturers for about five years and could then acquire title to the machinery by the payment of a relatively small additional amount. The Tax Court there held that the monthly amounts paid were not deductible as rentals because the taxpayer acquired an equity interest in the machinery.

If the term "equity" were to be used in the sense that the Petitioner contends, rentals relating to all leases would be denied deduction under Section 23 (a) (1) (A) because every lessee would have a so-called "equity" in the lease.

(b) Said rentals were ordinary and necessary expenses deductible under Section 23 (a) (2) of the Internal Revenue Code.

Section 23 (a) (2) was added to the Internal Revenue Code to avoid the type of argument advanced by the Petitioner and to permit an individual to deduct amounts spent in income producing activities or in managing and maintaining his investments even though he is not carrying on a business as such. See *Prentice-Hall, Federal Taxation Service, Vol.* 2, 1955, paragraph 12,003, at page 12,012, stating:

> "Non-business rentals.—In addition to Sec. 162 (Paragraph 11,004) permitting the deduction of rentals as business expenses, Sec. 212 (paragraph 11,140-A) permits individuals to deduct 'all the ordinary and necessary expenses paid or incurred during the taxable year for the production or collection of income, or for the management, conservation, or maintenance of property held for the production of income'."

In support of the above contentions, but at the same time without burdening the Court with the exhaustive authorities which exist, the following appears in 4 Mertens, *Law of Federal Income Taxation* (1953), *Cum. Pocket Supp., Section 25.118*:

"The Revenue Act of 1942 added to existing deductions a new deduction to include non-trade or non-business expenses. In this respect 'non-trade' and 'non-business' must be understood as shorthand expressions referring to expenses unrelated to the usual or principal trade or business of the taxpayer, rather than to those which are wholly personal or non-commercial. This amendment was made only after long efforts to obtain statutory sanction for deduction of non-business and investment expenses. After much litigation on the subject the Supreme Court in *Higgins v. Comm.* (312 U.S. 212, 85 L. Ed. 783, 61 S. Ct. 475 (1941) held that such expenses were not incurred in a 'trade or business' and therefore were not deductible. This decision set the stage for amendment of the law by the 1942 Act.

The change was made by Section 121 of the 1942 Act, which amends I.R.C., Sec. 23 (a) making the existing provisions thereof subparagraph '(1)', and adding a new subparagraph '(2)', which is as follows:

'I.R.C., Sec. 23 (a) (2). Non-trade or Non-business Expenses.—In the case of an individual, all the ordinary and necessary expenses paid or incurred during the taxable year for the production or collection of income, or for the management, conservation, or maintenance of property held for the production of income.' "

The Tenth Circuit had the issue here presented before it in the *Dougan* case, supra, and disposed of this technical argument as follows:

"We find it unnecessary to resolve the doubts concerning deductibility on either point, for we are convinced that these rental payments fall squarely within the provisions of Section 23 (a) (2) of the Code, as ordinary and necessary expenses paid or

> incurred during the taxable year for the production or collection of income, or for the management, conservation, or maintenance of property held for the production of income. See 4 Mertens, Law of Federal Income Taxation, 1953 Cum. Pocket Supp., Sec. 25.120, page 441."

In summary, the Respondents contend that the payments are clearly deductible under Section 23 of the Internal Revenue Code, such deduction being permitted under Section 23 (a) (1) (A) because the partnerships in question and the Respondents were in a trade or business incident to the oil and gas leases, but even if it be assumed that they were not, the payments are deductible under Section 23 (a) (2).

CONCLUSIONS

On the basis of the foregoing, it is concluded that Federal rentals on oil and gas leases, whether for the first or a later year, are true rentals and, therefore, deductible under Section 23 (a) (1) (A) of the Internal Revenue Code assuming the lessees are in the oil business or under Section 23 (a) (2) if the lessees are not in the oil business. This conclusion is based on the following general points, all of which have been discussed heretofore:

(a) The statutes, the lease forms and the regulations denominate these fixed periodic payments as "rentals".

(b) These payments are true rentals since they are fixed sums payable annually for the purpose of holding the possession of property.

(c) Congress clearly distinguished between the single, non-recurring payment denominated bonus and the annual payments involved herein denominated rentals.

(d) These annual advance rentals are identical with the payment required by any landlord who offers to rent to the first comer for rentals payable annually and in advance, such rental admittedly being deductible.

Respectfully submitted,

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